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Supreme Court of the United States

OCTOBER TERM, 1941

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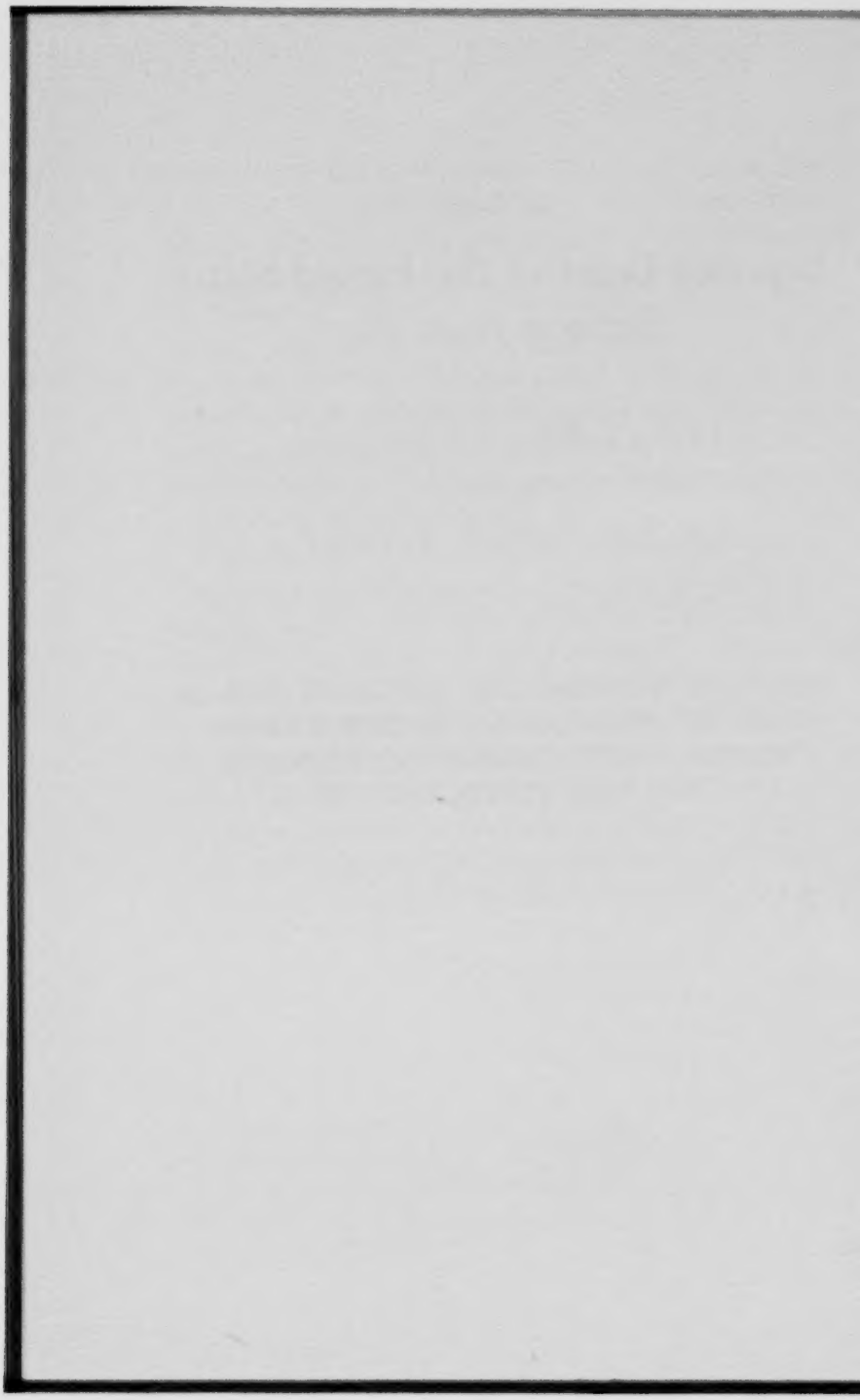
MARRS McLEAN, Petitioner
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT



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I.

OPINION BELOW.

The opinion of the Circuit Court of Appeals for the Fifth Circuit is reported in 120 F. (2d) 942. (R. 353.)

II.

JURISDICTION.

The jurisdiction of this court is invoked on the following grounds:

(1) The judgment to be reviewed was entered on June 20, 1941. (R. 353.)

(2) The Board of Tax Appeals had jurisdiction of this case under Section 274(a) of the Revenue Act of 1926 (44 Stat. 55), as amended by Section 501 of the Revenue Act of 1934 (48 Stat. 755); I. R. C. 272. The appeal to the Circuit Court of Appeals was taken in pursuance of Section 1141 I. R. C.

(3) The jurisdiction of this court is invoked under Section 240(a) of the judicial Code, as amended by Act of February 13, 1925. (43 Stat. 938.)

(4) Under Rule 38(5) of this Court, a review on writ of certiorari will be granted where there are special and important reasons therefor. There are special and important reasons why this cause should be reviewed by this Court. Those reasons are set forth in the petition (*supra*, pp. 8-18), and in the interest of brevity will not be repeated here.

III.

STATEMENT OF THE CASE.

The essential facts of the case are fully stated in the petitioner's petition for certiorari, and in the interest of brevity are not repeated here. Any necessary elaboration of the evidence on the points involved will be made in course of the argument which follows.

IV.

The pertinent Statutes involved are set out in the appendix A, *infra,* pp. 37-39.

V.

SPECIFICATIONS OF ERROR.

1. The court below erred in holding that the transaction which the petitioner entered into with the Yount-Lee Oil Company on March 18, 1931, did not constitute a sale within the purview of the Capital Gains Provisions of the Revenue Act of 1928.

2. The court below erred in holding that the transaction which the petitioner entered into with the Yount-Lee Oil Company on March 18, 1931, did not constitute a sale within the purview of the Capital Gains Provisions of the Revenue Act of 1932.

3. The court below erred in holding that the transaction which the petitioner entered into with the Yount-Lee Oil Company on March 18, 1931, did not constitute a sale within the purview of the Capital Gains Provisions of the Rvenue Act of 1934.

4. The court below erred in not holding that the cash consideration received by petitioner upon the transfer and assignment of the Cade leases to the Yount-Lee Oil Company on March 18, 1931, constituted gains derived from the sale of capital assets within the purview of the Capital Gains Provisions of the Revenue Acts of 1928 and 1932.

5. The court below erred in not holding that the amounts received by petitioner during 1931, 1932, 1933, 1934 and 1935 on account of the Two Million

Dollar payment, constituted gains derived from the sale of capital assets within the purview of the Revenue Acts of 1928, 1932 and 1934.

6. The court below erred in holding that the transaction which the petitioner entered into with the Yount-Lee Oil Company on March 18, 1931, did not constitute a "bona fide sale" within the purview of Section 102 of the Revenue Acts of 1928 and 1932.

7. The court below erred in not holding that the petitioner was entitled to the benefit of Section 102 of the Revenue Acts of 1928 and 1932, with respect to the amounts which petitioner received during the years 1931 to 1933, inclusive, on accocunt of the transfer of the Cade leases to the Yount-Lee Oil Company on March 18, 1931.

VI.

ARGUMENT.

The primary question presented by the decision of the Circuit Court for the Fifth Circuit in the instant case is whether petitioner's reservation of a royalty prevented his unconditional transfer of certain oil leases from constituting a *"sale"* within the purview of Sections 101 and 102 of the Revenue Acts of 1928 and 1932, and Section 117 of the Revenue Act of 1934.

Similar provisions are embodied in the Internal Revenue Code as Sections 105 and 117.

That the question presented is of public importance deserving review and authoritative decision is clearly shown by the promulgation of a memoran-

dum by General Counsel of the Bureau of Internal Revenue in June of this year (G.C.M. No. 22730), setting forth the Bureau's views in regard to this and other undecided questions arising out of oil and gas transactions.

1.

The Word "Sale" Should Be Given Its Ordinary Meaning.

There is nothing in the capital gains provisions of the Revenue Acts here involved, nor in similar provisions of any of the other Revenue Acts, which remotely indicates that Congress intended that the word *"sale"* was employed other than in its natural, ordinary and familiar sense.

Helvering v. Wm. Flaccus Oak Leather Co., (U. S. Sup. Ct. No. 627) Apr. 28, 1941.
Burnet v. Harmel, 287 U. S. 103, 108, 110.

Nor is there anything in the "Prospectors' Relief" provision (Sec. 102) of the Revenue Acts of 1928 and 1932, or the later Acts, which contains similar provisions for relief of those who, after years of fruitless prospecting and exploration, succeed in discovering oil upon their leases, which implies that the Congress intended that the word *"sale"* was used other than in its common meaning and ordinary sense.

Fowler v. U. S., 11 F. (2d) 895.
1 Paul & Mertens, p. 22, Sec. 2.05.

When given its ordinary meaning the word de-

notes "a contract whereby the absolute or general ownership of property is transferred from one person to another for a price or sum of money, or loosely, for any consideration." (Webster's New International Dictionary.) Or any transaction whereby property is parted with for a valuable consideration, whether there be a money payment or not, provided the bargain is made and the value measured in money terms is paid or agreed to be paid in something which the parties agree to treat as a specified amount of money. 23 C. J. 185. These definitions have received the repeated approval of this Court.

Williamson v. Berry, 8 Howard 495; 543.
Five Per Cent Cases, 110 U. S. 471.

2.

The Transaction Was Clearly a Sale.

On March 18, 1931, petitioner was the owner of certain oil and mineral leases in Galveston County, Texas, upon which he had, after years of effort and risk, succeeded in discovering oil in commercial quantities. (R. 215)

There can be no doubt that as the owner of such leases McLean was the owner of vendable real property.

Lynch v. Alworth-Stephens Co., 267 U. S. 364, 369.
Comm'r of Int. Rev., v. Fleming, 82 F. (2d) 324, 327.

On that day he transferred to the Yount-Lee Oil

Company, for a stipulated consideration, the title, possession and absolute ownership and control of the leases without restriction or limitation as to use, or provision for reversion, together with all oil well producing and operating equipment thereon, but less and except a twenty-five per cent royalty in the oil to be produced therefrom, out of which all outstanding royalties were to be paid, including that due the lessors.

The paper by which this transaction was memorialized recites that McLean is the *owner* of certain oil and mineral leases in Galveston County, Texas, and declares that,

> "* * * for the consideration hereinafter set forth (and subject to royalty reservation hereinafter contained), have GRANTED, SOLD, CONVEYED, TRANSFERRED AND ASSIGNED, and do by these presents GRANT, SELL, CONVEY, TRANSFER AND ASSIGN unto the Yount-Lee Oil Company * * * the following described oil, gas and mineral leases and the oil, gas and mineral leasehold estates created thereby (together with the hereinafter described physical properties and equipment), covering the following described lands in Galveston County, Texas, to-wit: * * *"

Following a description of the leases and the physical properties and equipment thereon, the instrument recites:

> "The *consideration* for this transfer and assignment of said above-described oil, gas and mineral leases and physical properties and equipment, is as follows:
> "(a) The sum of ONE HUNDRED THOU-

SAND ($100,000.00) DOLLARS CASH, * * *

"(b) TWO HUNDRED THOUSAND ($200,000.00) DOLLARS due and payable six (6) months after the date hereof, and TWO HUNDRED THOUSAND ($200,000.00) DOLLARS due and payable twelve (12) months after the date hereof; said deferred payment to bear no interest;

"(c) TWO MILLION ($2,000,000.00) DOLLARS to be paid out of one-eighth (1/8) of the (gross) oil produced and saved from the lands covered by the assignment, if, as and when produced and saved, and only in such event; it being expressly understood in this connection that said *YOUNT-LEE OIL COMPANY shall be under no obligation whatever to Grantor herein to drill upon or develop said land, or any part thereof, for oil.*" (Italics supplied.)

The "royalty reservation" referred to in the granting clause of the conveyance is provided for in the next paragraph of the instrument which also assured the Yount-Lee Oil Company of seventy-five per cent of the oil produced, without diminution by any outstanding royalties, over-riding royalties and/or interest of any character in the oil in, under or produced from the land. It recites:

"There is reserved and excepted from this assignment a royalty of twenty-five (25%) per cent of the oil produced and saved from the lands covered by this assignment, out of which twenty-five (25%) per cent royalty all outstanding royalties, (including royalties due lessors under the terms of said leases) and all overriding royalties are to be paid, and Grantor is to receive the balance of said twenty-five

(25%) per cent royalty; it being understood in this connection that said YOUNT-LEE OIL COMPANY shall in any event be entitled to receive seventy-five (75%) per cent of the oil produced and saved from said land, and that all outstanding royalties, overriding royalties, and/or interest of any character in the oil in, under or produced from said land shall be charged against the twenty-five (25%) per cent royalty herein reserved. Said YOUNT-LEE OIL COMPANY shall be entitled to free fuel oil for all operations on said land and the royalty shall be computed after deducting oil used for fuel. Grantor also reserves a royalty of twenty-five (25c) cents per long ton on sulphur but Grantor shall be under no obligation to develop said land for sulphur."

The next paragraph of the conveyance sets out a formula for pricing the oil produced from the land, for the purpose of calculating the amount to be currently applied against the Two Million Dollar payment, and for accounting to McLean for his share of the reserved royalty oil. It declares that:

"If oil is produced from the land covered by this assignment and said YOUNT-LEE OIL COMPANY runs such oil to its pipe line or to its storage (other than field tanks and temporary storage in the High Island field) then said Yount-Lee Oil Company is to account to Grantor, on the payment to be made to him out of oil and for his interest in the royalty oil, on the basis of the posted field price at the well in the Gulf Coast for oil of like grade and gravity posted by the following four (4) major pipe line companies: The Texas Pipe Line Company, Gulf Pipe Line Company, Humble Oil & Refin-

ing Company and Sun Pipe Line Company. In the event said Yount-Lee Oil Company *sells the oil produced from said land to others,* said YOUNT-LEE OIL COMPANY *shall account to Grantor* on the payment to be made to him out of oil and for his interest in the royalty oil, on the basis of the sale price at the well received by the said YOUNT-LEE OIL COMPANY." (Italics supplied.)

The habendum clause, which follows the foregoing provision, employs language identical with that used in such provisions containing the usual Texas general warranty clause. It follows:

"TO HAVE AND TO HOLD said above-described oil, gas and mineral leases and the mineral leasehold estates created thereby, and the physical properties and equipment above described, together with all and singular the rights and appurtenances, thereunto in anywise belonging, unto the said YOUNT-LEE OIL COMPANY, its successors and assigns, and I do hereby for myself, my heirs, executors and administrators, COVENANT AND WARRANT that I have full right to convey said above-described oil, gas and mineral leases and that each of said leases are not* encumbered, valid and in full force and effect; and I further hereby bind myself, my heirs, executors and administrators, to WARRANT AND FOREVER DEFEND all and singular the title to the land covered by said oil, gas and mineral leases unto the said YOUNT-LEE OIL COMPANY, its successors and assigns, against every person whomsoever lawfully claiming or to

* In the Stipulation of Facts, page 15, line 5, this word erroneously appears as "now."

claim the same, or any part thereof." (Italics supplied.)

The conveyance was executed in the usual Texas form, and is as follows:

"EXECUTED this 18th day of March, A.D. 1931.

/S/ MARRS McLEAN
YOUNT-LEE OIL COMPANY,
By /S/ M. F. YOUNT,
President.
Attest:
(Seal) /S/ F. E. THOMAS,
Asst. Secretary."

The foregoing instrument conforms with the statutory provisions of the State of Texas for the conveyance of real property. (R. 225.)

There is nothing within its four corners which remotely indicates that the parties intended to create as between themselves a relationship such as obtains between lessor and lessee. On the other hand, every term and provision thereof manifests the unequivocal intention of the parties to effect an unconditional transfer from McLean to the Yount-Lee Oil Company of the title, possession, ownership and control of the leases and the equipment thereon, less and except a twenty-five per cent economic interest in the oil in place, out of which all royalties were to be paid.

It is a fundamental principle of general law, consistently applied in the administration of the income tax acts, that where "parties enter into a written agreement which embodies and sets forth in full all the terms and conditions of their contract, their

intentions must necessarily be determined from and governed by such writing," and their "contract construed so as to effectuate such intention so far as the bounds of reason and justice will permit."

> First Seattle Dexter Horton Nat'l Bank, et al., v. Commissioner of Internal Revenue, 77 F. (2d) 45, 48, ~~(Cert. den. ——)~~.
> Jefferson Gas & Coal Co. v. Commissioner of Internal Revenue, 52 F. (2d) 120.

Any other rule would "frustrate the very ends for which parties contract in writing," *First Seattle Dexter Horton Nat'l Bank, et al., v. Commissioner of Internal Revenue,* 77 F. (2d) 45, 48, and substitute for the transaction they created one with legal and economic consequences flowing therefrom wholly different from that which they intended, and in conflict with the construction which they placed upon it in dealings between themselves and with third parties. (R. 348.)

3.

The Opinion Below is An Erroneous Interpretation and Improper Application of the Decisions of This Court.

The Circuit Court of Appeals held the transaction to be a sublease on the premise that petitioner's reservation of a royalty prevented the transaction from constituting a sale within the meaning of Sections 101 and 102 of the Revenue Acts of 1928 and 1932, and Section 117 of the Revenue Act of 1934. It is clear from the opinion of the court that its

decision rests entirely upon an erroneous interpretation and improper application of this court's decision in *Palmer v. Bender, supra.* The opinion states in part:

> "Precisely as in Palmer v. Bender, the taxpayer here, in the instrument of transfer reserved in himself an interest in the oil in place, and thereby and as a result thereof, secured for himself, 'income derived from the extraction of the oil to which he must look for a return of his capital.'
>
> "Precisely, as in Palmer's case, the taxpayer here retained a right to share in the oil to be produced, and an economic interest in the oil in place, which is depleted by production. Precisely as in that case, the taxpayer obtained as part consideration, for letting the sublessee in, a part of the fruits of the land as they might be produced, both as to the royalty and as to the payments in oil."

The same can be said of the transactions involved in *Thomas v. Perkins,* 301 *U. S.* 655; *Helvering v. Elbe Oil Land Development Co.,* 303 *U. S.* 372, *and Anderson v. Helvering,* 310 *U. S.* 404.

These decisions make it clear that provisions with respect to the reservation of royalty and stipulations for payment in oil are looked to solely for the purpose of determining "who has a capital investment in the oil and gas in place and what is the extent of his interest" *Anderson v. Helvering, supra,* at 407; never for the purpose of determining whether the transaction constituted a sale under the provisions of the Revenue Acts involved. Cf. *Helvering v. Elbe Oil Land Development Co., supra.*

The primary question in the *Palmer* case was whether or not the transferor of certain oil leases was entitled, under Section 214(a) of the Revenue Act of 1921, to deductions for discovery depletion upon cash, oil payments and royalties received under the terms of his transfers. The Government rested its denial of the deductions upon the ground that the amounts against which depletion was claimed represented proceeds from the sale of leases. The taxpayer contended that the transactions were subleases, and the cash an advance payment on account of royalties to be paid on oil to be produced. This Court sustained the taxpayer.

The decision did not turn upon the stipulation for oil payments and reservation of royalties, but was predicated upon a practical construction of the terms and provisions of the instruments of transfer and the percentage depletion statute involved. In the Smitherman transaction, under review in the Palmer Case, the terms and provisions with respect to performance of the conditions of the leases transferred, and the payment of an excess royalty, resembled the terms of a conventional oil lease; and created a relationship between the parties comparable to that which obtains between lessor and lessee, with legal and economic consequences which characterize such relationships. These circumstances marked the transaction as a sublease, as contended for by the taxpayer. This Court so held.

In the instant case the assignee was free of any obligation to perform the terms and covenants of the leases, and expressly relieved of any obligation

to drill upon or develop the land or any part thereof. Nor was there any stipulation in the agreement that the assignee should pay McLean as excess royalty a specified share of the oil to be produced. Petitioner simply excepted and reserved from his grant a "royalty of twenty-five per cent of the oil produced and saved * * * out of which * * * all outstanding royalties (including royalties due lessor under the terms of said lease) and all overriding royalties were to be paid."

These terms and provisions unmistakably show that it was the intention of the parties that McLean unconditionally divest himself of the Cade leases, the equipment thereon, and seventy-five per cent of the oil to be produced therefrom. The practical consequence thereof was to create a relationship such as obtains between vendor and vendee, and no other.

The court below overlooked that these circumstances and the practical consequences flowing therefrom distinguish the transaction in the instant case from that before the Court in *Palmer v. Bender, supra.*

In the Statutes and Treasury Regulations, and the opinion in *Palmer v. Bender, supra,* the word "royalties" is used in its plural and inclusive sense. It is evidence from the opinion of the court below that it has subdivided "royalties" into "royalty," (in its singular sense) and "oil payment," and given to each a value in determining the nature of the transaction. Cf. *Anderson v. Helvering, supra.*

It was upon this erroneous interpretation and

improper application of the decision in *Palmer v. Bender, supra,* that the court below was led to hold that the reservation of a royalty by the transfer of an oil and gas lease prevents the transaction from constituting a sale within the purview of the "Capital Gains" and "Prospectors' Relief" provisions of the Revenue Acts.

Such a rule not only conflicts with the decisions of this Court with respect to the basis for determining the nature of such transactions for the purpose of income taxation, but in addition, gives to the word *"sale"* a strange and unusual meaning—in conflict with the common understanding and accepted denotation of that word as approved by this Court—and, moreover, deprives owners of oil and gas leaseholds of the benefits enjoyed by all other taxpayers, free of such restrictions and limitations. That the Congress did not intend to deny to such owners the benefits of these provisions of the Act is not open to doubt or dispute.

CONCLUSION.

It is, therefore, respectfully submitted that this case is one calling for the exercise by this Court of its supervisory powers, to the end that a writ of certiorari should be granted, and that this Court should review the decision of the Circuit Court of Appeals and reverse and modify it in the particulars mentioned, as the rights of petitioner require.

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